Basel Committee on Banking Supervision

BANK FOR INTERNATIONAL SETTLEMENTS

Looking ahead by looking back

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Excellencies,

Governors and Heads of Supervision (past and present),

Sir John Vickers,

Distinguished members of the Basel Committee,

Ladies and gentlemen,

Good morning, sabah al kheir, and welcome to the 20th International Conference of Banking Supervisors (ICBS).

I would like to express my sincere thanks to Governor Mubarak Al Mansoori and the Central Bank of the United Arab Emirates (UAE) for hosting us in this splendid venue. This is the Year of Zayed, marking 100 years since the birth of Sheikh Zayed bin Sultan Al Nahyan, the first President of the UAE. And this Sunday (2 December 2018) will mark the 47th National Day of the UAE under the theme of "This is Zayed. This is the UAE.". Sheikh Zayed's long-term vision transformed the UAE into the remarkable and prosperous country that it is today, and I have no doubt that this is only the beginning for this country.

This is the 20th ICBS organised by the Basel Committee. The first one took place on 5-6 July 1979 in London, with over 200 participants from 83 countries. The structure of the conference was very similar to our conference today, with three topical workshops held during the day along with panel discussions. Some of the topics discussed at that ICBS included the supervision of international bank lending, banking supervision on a consolidated basis, and the regulation of banks' foreign exchange business. The Basel Committee chairman at that time, Peter Cooke (Head of Banking Supervision at the Bank of England) opened the conference by setting out his vision for the ICBS. As he put it, the aim of the ICBS is not "to achieve formal agreement on any issues…there will be no votes, no resolutions…I would hope however that there may emerge a broad-based consensus on a number of issues which will be discussed in the course of the sessions".[2] Cooke also stressed that the ICBS was an opportunity for the Basel Committee to "have the benefit of the comments of all [participants] who are concerned in the matters it is discussing". This vision continues to hold almost forty years later.

The theme of this year's conference is about looking back in order to look ahead more effectively. This ICBS coincides with the 10-year anniversary of the global financial crisis. So it is an opportune time to look back at what happened over the past 10 years, and what this means for the years ahead.

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1 I would like to thank Neil Esho, Marc Farag and Ethan Goh for their substantive contribution and comments. The views expressed are my own and do not necessarily reflect those of the Basel Committee or the BIS.

2 See Cooke (1979).

Looking back: "The enemy is forgetting"

I thought that, in the time that I have today, I would list the Basel Committee's publications over the past 10 years. There are over 350 such publications, so luckily for you, I don't have that much time!

The past decade has certainly been a productive one from the regulatory perspective. Indeed, much has been said about the causes, lessons, and regulatory and supervisory responses to the global financial crisis. The usual narrative is to go through the various episodes of bank distress and highlight the positive responses by policymakers. As I have done this myself on several occasions, I do not plan to go through these issues in detail today.[3] Instead, I would like to highlight a few vignettes from the past decade that illustrate the real costs of the crisis.

Consider first the shipping industry. Maritime transport is the backbone of global trade. Whether it's through Port Zayed here in Abu Dhabi or the Port of Shanghai, billions of tonnes of goods are shipped each year.[4] The global financial crisis struck at the heart of this important industry. To give just one example, the Baltic Dry Index – which measures the demand for shipping capacity – reached a record high level in May 2008 before plummeting by 94% in December that year to its lowest level since 1986.

Another casualty of the crisis was the automotive industry. With almost 100 million vehicles produced last year, the industry is another pillar of the global economy.[5] And yet it was in critical condition following the onset of the global financial crisis. For example, two of the three biggest US automakers (which collectively employed 1.6 million people at that time) were staring at bankruptcy and liquidation. This prompted an $80 billion bailout by the US government to prevent such an outcome.[6]

What about households' savings? In 2008, money market mutual funds (MMMFs) managed $5 trillion in assets globally. The "breaking of the buck" of the Reserve Primary Fund on 16 September 2008 saw the value of its shares drop from $1 to 97 cents. Following the announcement, investors withdrew $200 billion from prime MMMFs. But it was not an isolated event. What is perhaps less known is that up to 28 other MMMFs broke the buck in 2008, with one fund losing nearly 10% of its value.[7]

And it was not just the private sector that was painfully exposed to the effects of the crisis. Since 2007, there has been a continuous rise in the global stock of public and private debt, reaching almost 220% of global GDP at the end of last year, with global government debt increasing by more than a third during this period.[8] This build-up in debt levels reflects in part the sheer scale of government interventions in response to the financial crisis. A recent research paper estimates the direct costs of bailouts from the crisis in the US alone to have been about $500 billion, with a further $400 billion fiscal stimulus package.[9] Put differently, a crisis that was triggered by unsustainable levels of leverage has resulted in even higher levels of leverage. Growth in public sector debt has more than replaced the decline in private sector debt.

None of the examples that I have highlighted relate to the distress experienced by banks during the financial crisis. This is deliberate, as our ultimate focus as central bankers and supervisory authorities isn't about a bank failing, but rather the impact of that failure on the real economy and the provision of financial services to households and businesses.

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3 See, for example, Coen (2017a, 2017b and 2018) and Ingves (2014, 2015, 2016b, 2018).
4 See UNCTAD (2017).
5 See OICA (2017).
6 See US Department of the Treasury (2012).
7 See Cipriani et al (2013).
8 See BIS (2018).
9 Lucas (2018).

These snapshots, while anecdotal in nature, help to portray the global and multifaceted impact of the financial crisis, which continues to scar us to this day. Recent research by the IMF suggests that output levels remain below pre-crisis trends in more than 60% of economies.[10] Importantly, this includes advanced and emerging market economies that did not suffer a systemic banking crisis in 2007–08, and painfully illustrates the negative cross-border spillover effects of financial crises. For example, the UAE was not immune from the effects of the global financial crisis. Dubai World, the investment company behind many of the spectacular projects in Dubai (such as The Palm Islands and The World), faced a debt standstill in November 2009, resulting in a $10 billion aid package from Abu Dhabi.[11]

These effects are seen not just in economic and financial numbers, but in societal patterns at large. Recent research has shown how post-crisis global economic performance has had a significant impact on both migration and fertility rates, with these long-lasting effects yet to be fully felt.[12] There are now fewer graduates entering the financial sector, with an increasing number opting for what some may view as more socially useful activities![13]

As former Federal Reserve Board Chairman, Ben Bernanke, said recently, "For those working to keep our financial system resilient, the enemy is forgetting".[14] As we look forward, we simply cannot afford to forget the devastating impact of financial crises. As memories fade, don't underestimate how difficult it will be to not forget, or to not become complacent. Sooner or later, we will again hear the mantra that "this time it's different".

Looking ahead: mission accomplished?

I hope I have jolted your memory of the impact of the global financial crisis. A key question for us today is whether we have done enough, and what lies ahead in terms of future challenges and risk.

The main elements of the Basel Committee's post-crisis reforms are well known.[15] These include improving the quality of bank capital, increasing capital requirements, enhancing risk capture and reducing excessive risk-weighted asset variability, constraining leverage by imposing a minimum leverage ratio and incorporating macroprudential and liquidity risk elements into the Basel framework.

These reforms have strengthened the resilience of the banking system. Since 2011, the leverage ratio of internationally active banks has increased by almost 70%, and now stands at around 6%.[16] The Common Equity Tier 1 (CET1) risk-weighted ratio has increased by 80%, from around 7% to 13%. Banks now fund themselves with 85% more CET1 capital, and hold 50% more high-quality liquid assets.

But have they gone far enough? This is an important question, 10 years after the start of the crisis. This is why the Committee has put in place a comprehensive work programme to evaluate the effectiveness, interaction and coherence of its reforms. I cannot do the question justice in my remarks today, but I'll offer the following observations:

- There *will* be another financial crisis. This is almost a certainty with a fractional reserve banking system that relies on leverage and maturity mismatch. Our job as regulators and supervisors is not to *prevent* future crises, but to *reduce their likelihood*, and perhaps more importantly, their

10 See IMF (2018).
11 See Reuters (2009).
12 See GBD (2018) and IMF (2018).
13 See *The Economist* (2017).
14 Bernanke et al (2018).
15 See Ingves (2018) and BCBS (2017) for a more detailed summary.
16 See BCBS (2018).

impact on the real economy. And whether the next crisis starts from within the banking system, the shadow banking system, central counterparty clearing houses or another part of the financial system, it will affect the banking system in one way or another.

- There will be a "Basel IV" at some point in the future, even if it may not be called as such. There are no shortages of risks looming across the financial system, and we are witnessing financial innovation taking place at a dizzying pace. The regulatory framework needs to adapt to new risks and lessons learned from the crisis. Rest assured: I don't expect Basel IV to happen anytime soon (though some in the industry may think that it already has happened)! But I can say with a fair degree of certainty that the Basel framework in place today will not be the same one in place at the 30th ICBS.
- Despite our collective best efforts in strengthening the regulatory framework, the final Basel III framework represents a consensus among Committee members, which in turn means that it may not necessarily reflect a theoretically "first best" outcome. Put differently, some aspects of the framework, whether the overall calibration or the risk weights for specific asset classes, may be more justifiable from a narrow shorter-term perspective than a longer-term financial stability viewpoint.

Importantly though, the Basel framework includes a number of levers to allow jurisdictions to apply additional safeguards if needed. First, the framework consists of minimum standards, and jurisdictions are free to, and encouraged to, apply higher standards if warranted for their banking systems. There are many examples of such measures that have been applied across a number of jurisdictions.

Second, an important element of Basel III is its macroprudential framework, which allows for a global coordinated approach for authorities to continuously monitor emerging system-wide risks. If needed, jurisdictions can respond to such risks by activating or increasing the countercyclical capital buffer, and other Committee jurisdictions are expected to reciprocate such decisions. We have already seen this framework put into practice, and I encourage all jurisdictions to make use of this tool as the credit cycle evolves.

Third, any known gaps or "second best" outcomes in the minimum requirements (Pillar 1) framework can, and should, be supplemented through robust and rigorous supervision. This means that supervisors will need to go even further in overseeing banks' activities, changes in business models and emerging risks. It will inevitably require them to take decisions that may be viewed as unpopular in the short term, but which will help strengthen financial stability over the medium term. As has often been said – supervisors' value is greatest at a time when they are valued least. And, more than ever, it means that international collaboration among central banks and supervisory authorities is critical.

I will end with one final observation. The global financial crisis raised fundamental questions about ethics, incentives and moral behaviour. While there have been a set of global and national post-crisis measures related to conduct, accountability and governance, the breach in trust between the banking system and the general public has yet to be restored. Some banks are fond of saying that, 10 years after the crisis, it is time to move on. And yet, 10 years after the crisis, we continue to see episodes of bank practices that breach any basic ethical and moral principles. I think more may be needed to instil these principles in the financial system and help restore the adage that "my word is my bond".

Conclusion

In conclusion, the Basel Committee's comprehensive post-crisis reforms have undoubtedly enhanced the resilience of the banking system. That increased resilience is there for a reason: there is no shortage of risks in the financial system today, and the likelihood of a future financial crisis occurring only increases with time. To mitigate the impact and likelihood of future crises, it is imperative that the Committee's reforms be implemented by its members in a full, timely and consistent manner, and that central banks and supervisory authorities remain alert to emerging risks and take additional regulatory and supervisory actions where needed. And it is important that we keep an open mind as to whether we have gone far enough in strengthening the resilience of the financial system.

As Sheikh Zayed once said, "He who does not know his past cannot make the best of his present and future, for it is from the past that we learn."[17] We have the opportunity over the next two days to review the lessons from the global financial crisis and prepare ourselves for the years ahead. I wish you an enjoyable and productive conference.

17 Al Ash-Shaykh (2017).

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